No. 3090

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

HAIKU SUGAR COMPANY, PAIA PLANTATION, KALIALINUI PLANTATION COMPANY, LIMITED, PULEHU PLANTATION COMPANY, LIMITED, KULA PLANTATION COMPANY, LIMITED, MAKAWAO PLANTATION COMPANY, LIMITED AND KAILUA PLANTATION COMPANY, LIMITED, COPARTNERS DOING BUSINESS UNDER THE FIRM NAME OF MAUI AGRICULTURAL COMPANY,

Plaintiffs in Error,

VS.

RALPH S. JOHNSTONE, EXECUTOR UNDER THE WILL AND OF THE ESTATE OF JOHN F. HALEY, LATE COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF THE TERRITORY OF HAWAII,

Defendant in Error.

17

BRIEF OF DEFENDANT IN ERROR

Upon Writ of Error to the United States District Court for the Territory of Hawaii

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Filed this..... .....day of February, 1918.

FRANK D. MONCKTON, Clerk,

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Defendant in Error.

BRIEF OF DEFENDANT IN ERROR.

STATEMENT OF CASE.

The plaintiffs in error are all corporations, and were plaintiffs in an action in the District Court of the Territory of Hawaii to recover from one

John F. Haley, Collector of Internal Revenue of Hawaii, the sums of $2,098.83, $10,669.56 and $27,884.51, aggregating $40,652.90, paid under protest by said plaintiffs in error on September 8, 1916, as income taxes for the years 1913, 1914 and 1915 under the Federal Income Tax law of October 3, 1913.

The action was brought by said plaintiffs in error as copartners doing business under the firm name Maui Agricultural Company, and the only question of importance to be determined to ascertain whether or not the plaintiffs in error are subject to the tax imposed by the Government is whether the Maui Agricultural Company is a partnership. If it is a partnership, and the complaint states sufficient facts to constitute a cause of action, then the plaintiffs in error should succeed, otherwise the lower court pursued the right course in sustaining the government's demurrer.

Since the plaintiffs in error chose to stand upon the complaint, all of the facts to be considered in determining this appeal appear in said complaint. (Tr. pp. 9-56.)

ASSIGNMENTS OF ERROR.

It is claimed first that the Court erred in sustaining the demurrer of the defendant to the complaint of the plaintiffs, and in ordering judgment for the defendant.

II.

That the Court erred in entering judgment for the defendant and against the plaintiffs.

III.

That the Court erred in holding that the plaintiffs herein, doing business under the name of the Maui Agricultural Company, are a joint stock company or association within the meaning of Paragraph "G" of Section II of the Act of October 3, 1913.

IV.

That the Court erred in holding that the plaintiffs herein, doing business as the Maui Agricultural Company, are not a copartnership within the meaning of Paragraph "G" of Section II of the Act of October 3, 1913.

V.

That the Court erred in holding that the plaintiffs were subject to the tax imposed by Paragraph "G" of Section II of the Act of October 3, 1913.

VI.

That the Court erred in holding that the plaintiffs take nothing by their said action.

ARGUMENT.

The opinion of the Honorable Horace W. Vaughan (Tr. p. 65) briefly surveys the whole sit-

uation, and on pages 66 and 67 of said transcript he says:

> "The question in the case is whether or not paragraph "G" of Section II of the Act of October 3, 1913, required by levy and assessment against the Maui Agricultural Company of the tax which said paragraph provides 'shall be levied, assessed,' etc., against 'every corporation, joint stock company or association and every insurance company, organized in the United States, no matter how created or organized, not including partnerships.' And the determination of this question depends upon whether the Maui Agricultural Company is a corporation or a joint stock company or association within the meaning of paragraph "G" of Section II of the Act of October 3, 1913, or is a 'partnership' within the meaning of the word as used in said paragraph of said Act. If it is neither a corporation nor a joint stock company or association, the paragraph imposes no tax upon it; if it is a 'partnership' within the meaning of the word as used in the paragraph it is not subject to the tax. It becomes necessary, therefore, to ascertain the meaning of the paragraph as affecting the question involved, and also to determine what kind of creature the Maui Agricultural Company is."

Before going into the merits of the question concerning whether or not the Maui Agricultural Company is or is not a partnership, the government desires to attack the complaint as failing to state

sufficient facts to constitute a cause of action against the defendant in error, in this: There is no allegation in said complaint showing that the said corporations, and each of them, possessed the authority and right, through their, and each of their charters or articles of incorporation, to enter into a copartnership agreement or otherwise associate themselves as copartners, and the general rule is that a corporation has not such power, unless expressly authorized.

1831, *Sharon Canel Co.* v. *Fulton Bank,* 7 Wend. (N. Y.) 412;

1858, *Whittenton Mills* v. *Upton,* 10 Gray (Mass.) 582, 71 Am. Dec. 681;

1862, *Marine Bank* v. *Ogden,* 29 Ill. 248;

1885, *Gunn* v. *Central R. Co.,* 74 Ga. 509;
News Register Co. v. *Rockingham Pub. Co.,* 86 S. E. 874;

1890, *People* v. *North River Sug. R. Co.,* 121 N. Y. 582, 18 Am. St. Rep. 843, *supra* p. 100;

1895, *Aurora Bank* v. *Oliver,* 62 Mo. App. 390;

1897, *Sabine Tram Co.* v. *Bancroft,* 16 Texas Civ. App. 170, 40 S. W. Rep. 837;

1899, *Merchants' Nat'l Bank* v. *Standard W. Co.,* 6 Ohio N. P. 264;
Bates 1, Partnership, Sec. 1;
1 Lindley, Partnership, Sec. 86.

The mere fact that the laws of Hawaii permitted corporations to combine for the purpose of forming a copartnership, does not indicate that the charters or articles of incorporation of each of the respective corporations give them sufficient power to organize and participate in copartnerships. It was therefore necessary that the complaint specifically allege facts to show that each of said corporations possessed the power, through their respective charters or articles of incorporation to organize a partnership and participate in its activities, and that the action of said corporation was not *ultra viries.*

The pleadings in this case, as in all other cases, are to be construed most strongly against the pleader.

31 Cyc. pp. 78, 79, 81 and 82 and cases cited, and since it was material in this case for the plaintiffs in error to show that said corporations and each of them possessed sufficient power through their respective charters to organize a partnership, a failure on the part of the complainant to allege this material fact gives rise to the presumption that the said charters did not grant sufficient power.

Frantz vs. *Patterson,* 123 Ill. App. 13;

Cannon vs. *Castleman,* 162 Ind. 6, 69 N. E. 455;

Hughes vs. *Murdock,* 45 La. Ann. 935, 13 So. 182;

Chicago, etc., R. Co. vs. *Shepherd,* 39 Nebr. 523, 58 N. W. 189;

Stillings vs. *Van Alstine,* 2 Nebr. 684, 89 N. W. 756;

Marsh vs. *Marshall,* 53 Pa. St. 396.

The next and important question is to determine whether the Maui Agricultural Company is a partnership, or is it to be classed as a corporation, joint stock company or association, and subject to the income tax law of 1913.

While the Maui Agricultural Company has practically all of the characteristics of a corporation, technically speaking, it is not a corporation, as it is not a legal entity brought into existence by a sovereign power through legislative action and clothed with a charter, but is the result of an express agreement, (Exhibit "A", p. 28 Tr.) and supplemented with by-laws (Exhibit "B", p. 45 Tr.), both of which are framed along the same lines and in all respects analogous to the articles of incorporation and by-laws of an ordinary corporation.

An examination of the authorities show that the line of demarcation between a corporation and a joint stock company is not a very distinct one. They are so much alike in fact, that the joint stock company is sometimes called a *quasi* corporation.

Oak Ridge Coal Co. vs. *Rogers,* 108 Pa. St. 147,

1 Morawetz Corporation, Par. 6.

In volume 23 Cyc., page 23, the author states that

> "The difference has become obscure, elusive and difficult to describe",

and then the author calls attention to a distinction by stating as follows:

> "A corporation on the one hand is an artificial entity brought into existence by the sovereign power of the state, and the individual liability of its members is completely eliminated unless some part of that liability is expressly preserved by constitutional or statutory provision; while a joint stock company, on the other hand, is formed by a written agreement of individuals with each other, and its whole force and effect, in constituting and creating the organization, rest upon the common-law right and power of the individuals to contract with each other; the relation they assume is wholly the product of their mutual agreement and depends in no respect upon any grant of authority from the state; and hence the individual personal liability of the members remains intact unless there is express statutory authority for its elimination."

Generally speaking, the above distinction is as clear as can be drawn from any of the decisions rendered by the courts or from the texts written by eminent authors upon the subject and an examination of said agreement and by-laws of the Maui Agricultural Company will show that they, and each of them, meet every requirement of the above definition.

But can the Maui Agricultural Company be classed as a partnership, and if not, what distinction is there between a joint stock company and a partnership?

In discussing the law of partnerships in Mechems Element of Partnership, the author, on page 1 thereof, says that

> "Any attempt to frame a satisfactory definition of partnership is probably a somewhat hazardous undertaking. This is partly owing to the difficulty inhering in any attempt at definition, but it is chiefly attributable to the fact that the legal conception of partnership has not always been clear and definite, and that the legal test for determining the existence of the relation has varied from time to time. Mr. Justice Lindley, in his admirable treatise upon the subject, declines to attempt a definition, saying that to frame one 'which shall be both positively and negatively accurate is possible only to those who, having legislative authority, can adapt the law to their own definition.' "

The same author, on pages 2 and 3 of the same text, gives the principal characteristic elements of a partnership as follows:

> "1. It is an unincorporated association or legal relation.
>
> 2. It is created not by law but by the agreement of the parties.
>
> 3. It requires two or more competent parties.

4. It involves the establishment of a common stock, fund or capital of some sort by the union of the several contributions of the parties.

5. It contemplates the transaction of some lawful business, trade or occupation, which the parties to own and carry on as principles.

6. The purpose of the union is the pecuniary gain of the members."

and on page 6 of the same text, the author, in drawing a distinction between a partnership and a corporation, further defines a partnership as a—

"voluntary, unincorporated association of individuals whose legal relation is based upon their agreement, and needs no special statutory authority to give it force and effect. They continue to act in this relation as individuals. They sue and are sued only in their individual names. The death of one operates usually to terminate the relation. The transfer of the interest of one has usually the same effect, and operates, not to introduce the transferee into the relation, as a party to it, but merely to give him such share as his transferer would have upon a dissolution. Each partner is, in general, personally responsible for all the debts of the partnership, notwithstanding that he has fully paid in to it his agreed contribution."

A joint stock company is defined in Volume 23 Cyc., page 467, as follows:

"A joint stock company is an association of individuals for purposes of profit, possessing a

> common capital contributed by the members composing it, such capital being commonly divided into shares of which each member possesses one or more, and which are transferable by the owner."

Exhibit "A" (P. 31 Trans.), which represents the agreement between the corporations, composing the Maui Agricultural Company, provides as follows:

> "Division of Capital Stock.
>
> The capital stock of the said company shall be divided into thirty-five (35) equal shares or interests, of which twelve (12) shall belong to the said Haiku, eighteen (18) to the said Paia, and one (1) each to the said Kalialinui, Pulehu, Kula, Makawao, and Kilua."

and Exhibit "B" (P. 45 Trans.), which represents the by-laws of the said Maui Agricultural Company, contains the further provision, as follows:

> "The respective interests of the partners as set forth in the Articles of Partnership shall be evidenced by a certificate in such form and device as the Board of Managers may adopt."

It can readily be seen from the portions of the agreement and by-laws of the Maui Agricultural Company, as quoted above, that each corporation had a certain specific interest in said company to be "evidenced by a certificate in such form and device as the Board of Managers may adopt."

Counsel representing plaintiffs in error, in their brief, pp. 14 and 15, state as follows:

> "The fundamental distinction between a joint stock company and a partnership is the existence, in the one case and not in the other, of a capital stock divided into transferable unit shares. By reason of this, a joint stock company has, to a certain extent, a distinct entity analogous to that of a corporation, which is well brought out in Gibbons v. Mahon, 136 U. S. 549, while a partnership has no such distinct entity, as is well brought out in 1 Lindley, Partnership, 4, and 22 Am. & Eng. Enc. of Law, 2nd Ed., 75. Of course, even an ordinary partnership may be and often is treated, as a matter of form or convenience, as a distinct entity by business-men or in equity or under special statutory provisions, but in general and legally a partnership does not exist apart from its members. It is simply the members themselves doing business together instead of separately under a contract between themselves and themselves alone. There is a *delectus personarum,* or choice of members. A joint stock company is the result of an attempt to make a partnership as nearly like a corporation as that can be done by mutual agreement, as distinguished from statute, in respect of membership and continuity."

The foregoing distinction meets with my approval and the government respectfully submits that a reading of the said agreement and by-laws of said Maui Agricultural Company will show that the

latter is a joint stock company and not a partnership. The said agreement covers every material point that should be covered in the usual articles of incorporation, and the said by-laws might well represent those of any corporation. In fact, on pages 54 and 55 Trans., Article 14, the word "corporation" is used and no doubt the by-laws were taken from those used by corporations as the similarity is so great.

Is the certificate which represents the respective shares of the various corporations which compose the Maui Agricultural Company transferable, and is there anything in the articles of agreement (Exhibit "A") or the by-laws that would indicate that there is a *Delectus Personarum,* or choice of members? An examination of said agreement and by-laws will show that there is no provision in either that would prevent said corporations or either of them, which compose the said Maui Agricultural Company, from disposing of their, or each of their certificates of interest and "where the articles of an association are silent on the subject, certificates of stock may be transferred at the pleasure of the holders."

23 Cyc. p. 473;

Alvord vs. *Smith,* 5 Pick. (Mass.) 232;

Butterfield vs. *Beardsley,* 28 Mich, 412.

To further illustrate the similarity between joint stock companies and partnerships, the government

again quotes from page 7 of Mechem's Elements of Partnership, in which the author states:

> "In many of the states, statutes have provided for the organization of associations partaking more or less of the characteristics of both partnerships and corporations. Thus, there are joint stock companies, which usually are simply partnerships with transferable shares."

In fact, the rule is clearly stated on page 46 of counsel's brief, which the government now quotes, as follows:

> "See, for instance, the quotation made by the District Judge from the Century Dictionary (Tr. p. 74.) Parsons (1 Contracts, Sec. 144-5) says that the English statutory definition of a joint stock company as a 'partnership, whereof the capital stock is divided into shares, or agreed to be divided into shares, and so as to be transferable without express consent of all the copartners' is applicable to such companies in this country, and that 'in other respects, the differences between the law of joint stock companies and that of partnerships are not very many nor very important."

As above stated, each of the corporations composing the Maui Agricultural Company, owned a certain specific interest in the latter, and the by-laws of said Maui Agricultural Company specially provided that said interest was to be "evidenced by a certificate in such form and device as the

Board of Managers may adopt"; and, as stated *supra,* inasmuch as said agreement and by-laws of the Maui Agricultural Company placed no restrictions upon the sale of said certificates of interest, said certificates could be transferred, and thus the Maui Agricultural Company possesses all of the attributes of a joint stock company.

The stockholders of a joint company are personally liable except in so far as such liability may be limited by statute or special agreement for the debts of the company precisely as general partners are liable for the debts of the firm.

23 Cys. p. 474 and cases cited.

Here again the Maui Agricultural Company qualifies as a joint stock company, as the agreement specifically provide (Tr. p. 40) that—

> "All losses incurred by the company, if any, shall be borne by the parties hereto in the proportion of twelve thirty-fifths (12-35) by the said Haiku Sugar Company, eighteen thirty-fifths (18-35) by the said Paia Plantation and one thirty-fifth (1-35) each by the said parties of the Third, Fourth, Fifth, Sixth and Seventh Parts."

Morawetz says:

> "Joint stock companies may be cited as quasi corporations of a private character. They are associations having some of the features of an ordinary common law copartnership, and

some of the features of a private corporation. 1 Morawetz Corp. Sec. 6."

"As defined by an English statute, a joint company is a partnership whereof the capital is divided, or agreed to be divided, into shares, and so as to be transferable without the express consent of all the copartners. Abbott vs. Rogers, 16 C. B. 277, 292, 81 E. C. L. 278."

"A joint stock company is controlled by a board of directors, or governors like a corporation, and individual members cannot, as such, make contracts on its behalf. Topeka Bank vs. Eaton, 107 Fed. 1003."

"Under the Pennsylvania statutes such companies are quasi-corporations *de facto* partaking of the nature of limited partnerships. Briar Hill Coal, etc., vs. Atlas Works, 146 Pa. St. 290, 23 Atl. 326."

As a matter of fact, the similarity between a corporation and a joint stock company is so great that in at least one instance "it has been held that a foreign joint stock company which possesses all of the attributes and powers of a corporation may be taxed for doing business in a state other than that where it was organized, under a law imposing a tax on foreign corporations doing business within the state."

23 Cyc. p. 469 and cases cited.

On page 11 of the brief of plaintiff in error reference is made to the case of "Elliott vs. Freeman, 220 U. S. 178 and Roberts vs. Anderson, 226 Fed.

7, in which similar language in the excise tax law of 1909 was under construction and in which organization of the 'joint stock company or association' class were referred to interchangeably as 'unincorporated joint stock companies or associations, joint stock companies, joint stock associations' ", etc.

At the time that the opinions were rendered in the two cases cited *supra,* the Federal income tax law of 1909, and under which said opinions were rendered, applied to "every corporation, joint stock company or association, organized for profit and having a capital stock represented by shares organized under the laws of the United States, or of any state or territory", but, on account of the interpretation in the two cases just referred to material changes appeared in the wording of the federal income tax law of 1913. The significance of this change in the wording of the tax law can best be shown by quoting what Black, the author of Black on Income Taxes, said just after reviewing said cases cited and referred to herein. Section 268, page 382 of his text is as follows:

> "But it is important to notice that the Act of 1913 is made applicable to 'every corporation, joint stock company or association organized in the United States, no matter how created or organized.' In view of the decision above referred to, this change of language must be considered highly significant, and manifests an intention on the part of Congress to

apply the tax to all kinds of joint stock companies or associations, whether organized in accordance with the law of any given state or merely with such powers and characteristics as they may possess at common law. And the Treasury Department has ruled that: 'It is immaterial how such corporations are created or organized. The terms 'joint-stock companies' or 'associations' shall include associates, real estate trusts, or by whatever name known, which carry on or do business in an organized capacity, whether organized under and pursuant to State laws, trust agreements, declarations of trusts, or otherwise, the net income of which, if any, is distributed, or distributable, among the members or share owners on the basis of the capital stock which each holds, or where there is no capital stock, on the basis of the proportionate share of capital which each has invested in the business or property of the organization, all of which joint-stock companies or associations shall, in their organized capacity, be subject to the tax imposed by this act.''

In conclusion, the Government suggests that from the foregoing it appears that the only cases of partnership that are not included in the federal income tax law in question are those of the common law and simple type and not those with a limited liability and possessing practically every characteristic of a corporation, with the possible exception of being a legal entity and clothed with a charter. This leads to the further conclusion that the action of

the District Court of the Territory of Hawaii should be sustained.

Respectfully submitted,

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